

EXHIBIT B

An excellent example of a state order which operates to impede competition is the Washington Utilities and Transportation Commission's ("WUTC") recent Order in U S WEST's Washington rate case. In that Order, the WUTC found the "true" monthly incremental cost of local residential service, including a local loop, to be very low -- less than \$14. It found further that local competition could flourish under correspondingly low resale and unbundled facilities rates, without any impact on universal service values.¹

The WUTC utilized the typical sophistic tools used by state commissions generally to subsidize residential rates. These tools include: 1) using fictitious hypothetical "fantasy" costs and network spare capacity factors rather than a carrier's actual costs and network spare capacity factors; 2) allocating fixed costs for usage-based rates; 3) extending depreciation lives and using outdated depreciation methodologies; 4) imputing fictitious revenues from other subsidiaries; and

¹ The Fifteenth Supplemental Order in Docket No. UT-959200, April 11, 1996. U S WEST has appealed this Order to the King County Superior Court, Cause No. 96-2-09623-7 SEA. On April 29, 1996, the court stayed the rate decrease portions of the Order, on the basis that U S WEST would suffer substantial and irreparable harm unless \$91.5 million in rate decreases were stayed pending appeal. It is anticipated the decision on appeal will occur in the Fall of 1996. U S WEST will challenge on appeal both the revenue requirement and the cost-of-service findings of the Order. Although the WUTC found that \$10.50 per month plus the federal subscriber line charge of \$3.50 covers the incremental cost of 1FR service, including the loop, it argues that all loop costs are common costs and not the incremental cost of any service. U S WEST believes this to be fundamentally erroneous and contrary to all recognized economic opinion. Individual loop costs are caused by the customer ordering dedicated switched access to the network and are part of the cost of basic service.

5) setting rates at LRIC only without providing for recovery of joint, common, and legacy costs.²

The WUTC Order is a graphic demonstration of the risks to competition, to the goals of the 1996 Act, and to the viability of incumbent local exchange carriers ("LEC"), like U S WEST, posed by state commissions which -- in their pursuit of the lowest possible residential rates -- are allowed to set costs and prices while ignoring the clear anti-competitive impact of the regulatory strictures they try to maintain. It is also a good example of the need for Federal Communications Commission ("Commission") direction to state commissions which are not committed to achieving the goals of the 1996 Act.

The 1995 rate case was U S WEST's first full rate case since divestiture. It was filed to gain recognition of a realistic revenue requirement and because of the compelling need to restructure monopoly-era rates to accommodate local competition, unbundling, and resale. Central to the revenue requirement issue was the severely deficient capital recovery position in Washington, the lowest in U S WEST's fourteen-state service area and among the very lowest in the country.³

² See discussion in body of Comments at pp. 7-8.

³ The WUTC has long suppressed the rate of capital recovery in order to avoid any pressure on LFR rates. The WUTC refuses to authorize Equal Life Group ("ELG") for all vintages of plant placed since 1982/83, and has refused to recognize ELG at all until very recently. It utilizes very long service lives for the major plant categories, and, as a result, the Washington intrastate reserve deficiency is very large -- about \$500 million using economic lives. The WUTC's refusal to deal with realistic depreciation expense recovery, in the face of undeniable competition and technological obsolescence, has a two-fold impact: it ignores \$140 million in current revenue requirement and understates incremental cost of service by approximately 28%. See WUTC Order in Docket No. UT-940641, U S WEST Depreciation Petition,

For example, were the WUTC to recognize depreciation expense at the level routinely recognized by the Commission for Washington interstate, according to the data and studies produced in the last Washington three-way depreciation meeting just concluded last month, there would be an additional approximately \$100 million in intrastate depreciation expense.

During the 13 years between divestiture and the present, the WUTC relied on high access, toll, and business rates and a very low rate of capital recovery to protect 1FR rates. From 1983 to 1994, it rationalized this approach by asserting that local service in Washington, including the provision of carrier access, was a *de jure* monopoly, and heavily subsidized residential rates were therefore sustainable. This mistaken belief of the WUTC was its excuse for continuing to avoid confronting the need to lower toll, business, and access rates, recognize real current revenue requirement, and raise 1FR rates. Accordingly, U S WEST joined the new prospective local competitors in appealing the WUTC's *de jure* monopoly decision to the courts.

The King County Superior Court found, as a matter of law, that the WUTC never had authority to award local monopolies, despite WUTC's consistent belief and regulatory actions for more than 50 years that it did. The Washington Supreme Court unanimously affirmed the lower court in 1994.⁴

reversed and remanded in King County Superior Court Cause No. 95-2-16286-0 SEA; WUTC Order on Remand in Docket No. UT-940641, on appeal to King County Superior Court in Cause No. 96-2-09622-9 SEA.

⁴ In Re Consolidated ELI Cases, 123 Wn. 2d 530, 869 P.2d 1045 (1994).

Since this court decision, the WUTC has enthusiastically embraced the concept of competition as a principle, but unfortunately continues to refuse to allow U S WEST rate structures and levels commensurate with a fully competitive environment. Its actions, therefore, in fact, remain anti-competitive.

The result of the WUTC's recent Order is that U S WEST's 1FR rates are so low that no facilities-based competition can exist for residential service in the foreseeable future. And, the potential for local interconnection rates, rates for unbundled facilities and services, and rates for resold services are so low as to threaten the ability of U S WEST to adequately extend and maintain its portion of the public switched network in Washington, actions necessary for competition to truly work.

Substantially suppressing revenue requirement by ignoring realistic depreciation expense and using flawed cost models harms real competition by producing artificially low rates in the short run. The WUTC relies on an AT&T Corp.- ("AT&T") sponsored substantial revision of the Benchmark Cost Model ("BCM") developed by U S WEST, NYNEX Corporation, Sprint Telecommunications Company, Inc., and MCI Telecommunications Corporation ("MCI"), the purpose of which is to identify high-cost-to-serve census block areas of the country. AT&T's version of the BCM purports to be a TSLRIC study of U S WEST's actual cost of residential service in Washington.

AT&T's study of the incremental cost of local service, commonly referred to as the Hatfield Study, is fundamentally flawed.⁵ First, it is based on a study, the BCM, that is admittedly not suitable for establishing the TSLRIC cost of service in any one state. The BCM was designed only to identify high-cost-to-serve census blocks nationwide. Because of the immense scope of the BCM, it necessarily incorporates several simplifying assumptions that severely understate costs, if used to identify the incremental cost of local service in one state.⁶

Second, the inputs used by AT&T are grossly understated, omit important categories of cost, and are unauditable. AT&T introduced its study very late in the Washington case, not until the rebuttal stage, allowing insufficient opportunity for discovery and analysis of the study. The WUTC seized upon the study simply because the study supported, on its face, what the WUTC very much wanted to assert -- that current very low residential rates are compatible with a competitive environment.⁷

⁵ U S WEST addressed the way in which Hatfield Associates has "modified" the BCM, and its objections to those modifications, within the context of universal service funding issues, in its recently filed universal service Reply Comments. See Reply Comments of U S WEST, Inc., CC Docket No. 96-45, filed May 7, 1996, at 11-14. The Harris and Yao Affidavit also demonstrates some of the Hatfield Study's more significant defects. See Harris and Yao Affidavit (Exhibit A) at 26-27.

⁶ See U S WEST Reply Comments, supra n.4, 9.

⁷ The WUTC rejected U S WEST's cost studies, finding that three-year old, historical depreciation cost factors should be used, and that loop costs and all spare network capacity should be treated as a common cost. The failure to use current, forward-looking depreciation expense, and treating the substantial spare network capacity necessary to provide residential service on immediate demand as a common cost to be recovered by other services, greatly understates the incremental cost of 1FR service. Furthermore, eliminating any loop costs from 1FR cost analysis

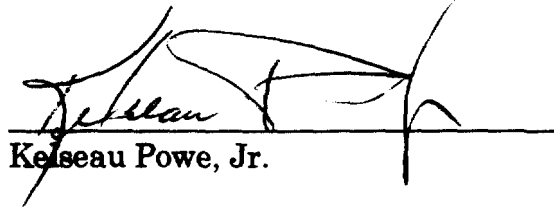
In point of fact, a residential service price which is cost based is approximately \$26.00 in Washington, and the evidence specifically documented this fact. U S WEST cannot invest in new facilities or otherwise implement the 1996 Act if its rates are maintained at below-cost levels by state regulations. Facilities-based competition likewise cannot develop under these circumstances. The Washington Order is a perfect example of how a state commission can take action which defeats the pro-competitive goals of the Act.

will produce absurdly low numbers -- less than \$5 per month, according to the WUTC.

Ironically, the WUTC severely punished U S WEST in its Order with disallowances and penalties because U S WEST's held orders are currently higher than historical levels, although not at levels exceeding that required by WUTC rules. Of course, held orders are a function of insufficient spare loop capacity, costs of which the WUTC refuses to recognize in the rates for services that cause the costs.

CERTIFICATE OF SERVICE

I, Kelseau Powe, Jr., do hereby certify that on this 16th day of May, 1996, I have caused a copy of the foregoing **COMMENTS OF U S WEST, INC.** to be served via hand-delivery upon the persons listed on the attached service list.



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